[JOINT COMMITTEE PRINT]

EXPLANATION OF H.R. 6806

RELATING TO

TREATMENT OF PUBLIC UTILITY PROPERTY UNDER SECTIONS 46(f) AND 167(l) OF THE INTERNAL REVENUE CODE

LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON NOVEMBER 19, 1980

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INTRODUCTION

This pamphlet provides an explanation of H.R. 6806, relating to the treatment of pubilc utility property under sections 46(f) and 167(l) of the Internal Revenue Code, scheduled for a public hearing on November 19, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. This bill was passed by the House of Representatives on September 25, 1980.

The first part of the pamphlet is a summary of the bill. This is followed by a more detailed explanation of the bill, setting forth present law, background, the issues involved, an explanation of the provisions of the bill, and the estimated revenue effect.

I. SUMMARY

The bill (H.R. 6806) would clarify the rules relating to the normalization requirements for public utility property eligible for the investment tax credit and accelerated depreciation. The bill also would provide a special rule which, in general, excuses violations of these requirements for certain past periods where such violations were a result of certain orders entered by a public utility commission prior to March 13, 1980.

With certain exceptions for companies that are grandfathered, public utilities are eligible to use the investment credit and to elect accelerated depreciation for tax purposes only if the tax benefits from accelerated depreciation and the investment credit (or, in some cases, a portion of the credit) are normalized for ratemaking purposes. Normalization generally requires that the tax benefits of accelerated depreciation and the investment credit not be treated for ratemaking purposes as a reduction in current Federal income tax expense, which is an element of a utility's cost of service, since that treatment would generally result in a direct reduction in the utility's revenues. Instead, the tax benefits are to be treated as investment capital that is supplied, in effect, by the Federal government to the utility through the tax system. The normalization rules for accelerated depreciation require that the utility retain the use of the deferred taxes but permit the deferred taxes to be treated as zero-cost capital on which the utility need not be allowed to earn an investment return; the normalization rules for the investment credit require a similar allocation of benefits between utility shareholders and utility customers. The normalization rules relating to accelerated depreciation were imposed in 1969, and the normalization rules relating to the investment credit, for the most part, were imposed in 1971 and 1975.

The bill would provide that violations of the normalization requirements of present law (and of the bill) will not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if such violations involved the use of estimates, projections, or rate of return adjustments (1) that applied for any period ending prior to March 1, 1980, and (2) that were included in certain orders of a public utility commission which were entered prior to March 13, 1980. This special rule is designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of A.T. & T.), General Telephone Company of California (a subsidiary of General Telephone & Electronics), and Southern California Gas Company.

The bill would amend the present normalization rules relating to accelerated depreciation and the investment tax credit to make it clear that certain ratemaking procedures involving the use of inconsistent estimates or projections do not comply with such rules. It also would give the Treasury Department specific authority to provide regulations setting forth conditions under which ratemaking adjustments are inconsistent with normalization. The amendments to the normalization rules generally would apply to taxable years beginning after December 31, 1979.

II. EXPLANATION OF THE BILL

A. Present Law

Accelerated depreciation

In general

Accelerated methods of depreciation, i.e., methods of depreciation that are faster than straight-line depreciation over the useful life of an asset, were enacted in the Revenue Act of 1954 (Code sec. 167). Congress made this form of depreciation available because it believed that accelerated depreciation would increase investment in new equipment and processes.[1]

Accelerated depreciation for public utilities

When accelerated depreciation was provided under the 1954 Code, there were no special provisions relating to the treatment of accelerated depreciation for regulated utilities. The stated congressional intent was to stimulate the economy by fostering capital formation. However, because Federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the reduction in current tax liability resulting from accelerated depreciation as a reduction in current cost of service and therefore flowed through the resulting tax benefit to customers currently by reducing rates. This practice, which is known as "flow-through" ratemaking, meant that accelerated depreciation would provide no direct investment incentive to public utilities.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, Code section 167 was amended as part of the Tax Reform Act of 1969. Under Code section 167(l), except for utilities with respect to which prior flow-through treatment for certain types of property was grandfathered, a utility could thereafter use accelerated depreciation for Federal tax purposes only (1) if the utility used a "normalization" method of accounting in its books of account and (2) if the regulatory agency used a normalization method of setting rates.[2]

Code section 167(l)(3)(G) provides that:

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[1] Subsequent congressional action with respect to depreciation generally has involved approval of a method to reduce the useful lives of assets so that depreciation may be calculated over a shorter period (such as the Asset Depreciation Range (ADR) system adopted in 1971 and various special 5-year amortization provisions). This is a different form of accelerated depreciation, but it tends to produce the same effect as a faster rate of depreciation in the calculations of a potential investor.

[2] In general, these rules apply to public utility property used in a public utility activity. Property is public utility property if, during any period, it is used predominantly in a public utility activity. Public utility activities to which the depreciation method limitations apply mean the trade or business of furnishing or selling:

(1) Electrical energy, water, or sewage disposal services;
(2) Gas or steam through a local distribution system;
(3) Telephone services;

"In order to use a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Treasury Regulations (§ 1.167(l)–1(h)) have interpreted this section to require that: (1) a utility's tax expense for ratemaking purposes must be computed as though straight-line depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed using accelerated and using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from the rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service. The Treasury Regulations (§ 1.167(a)–11(b)(6)) also interpret section 167(l) as requiring that, in addition to the benefits of accelerated methods of depreciation, the benefits of shortened useful lives under the ADR system must be normalized.

Thus, a normalization method of accounting results in the temporary tax reductions from accelerated depreciation being retained by the utility as a source of cost-free capital for which the utility customers need not pay the utility an investment return.

By allowing utilities to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: first, to assure that the deferred taxes resulting from accelerated depreciation would be available to the utilities as investment capital until paid to the Treasury and, second, to avoid the possible loss of Federal tax revenues that it believed would result because flow-through ratemaking would reduce the taxable income of utilities.

Investment tax credit

In general

The investment tax credit was enacted initially in the Revenue Act of 1962 (generally at 7 percent, except as noted below for public utilities). In 1964, Congress repealed a provision in the 1962 Act which required that the basis for depreciation of eligible property be reduced by the amount of the credit. In 1966, the credit was suspended during a period of rapid investment growth, and the credit was restored in 1967 when the rate of investment growth subsided.

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(4) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or

(5) Transportation of gas or steam by pipeline,

if the rates for the furnishing or sale are established or approved by certain regulatory bodies.

The investment credit was repealed as of April 18, 1969, in the Tax Reform Act of 1969, but was reenacted in the Revenue Act of 1971. In 1975, the investment credit was increased to 10 percent temporarily, and the 10-percent credit rate was made permanent in the Revenue Act of 1978.

The Energy Tax Act of 1978 enacted a 10-percent energy investment tax credit for various kinds of energy-related property. This credit was expanded, and increased to 15 percent in certain cases, in the Crude Oil Windfall Profit Tax Act of 1980.[3]

Investment tax credit for public utilities

Congress initially made a partial investment credit (3 percent instead of 7 percent) available to regulated public utilities. The reduced rate was a compromise between those who argued that utilities should be treated like other industries and those who argued that because the rates charged by regulated public utilities were intended to provide them with the opportunity to earn a satisfactory rate of return, they did not need Federal tax incentives to encourage capital investment.

In the Revenue Act of 1964, Congress provided that no Federal regulatory agency could flow through the tax saving from the investment credit to customers more rapidly than ratably over the useful life of the property. In addition, no Federal regulatory agency could require flow-through of any part of the credit in the case of any other property of a regulated company. Neither of these prohibitions would apply if the company consented.

When Congress restored the investment tax credit at a 7-percent rate in the Revenue Act of 1971, the investment credit for public utilities was increased from 3 percent to 4 percent. The increased credit was provided because many utilities were encountering problems in raising capital for modernization and expansion. An additional reason for the credit was to improve the competitive position of regulated utilities against unregulated companies which provide some of the same services. (The 1971 Act also reduced the credit allowable to unregulated taxpayers to 4 percent for certain property used in competition with public utility property.)

When Congress restored the investment credit in 1971, it generally provided that the investment credit would not be available to regulated public utilities unless the benefits of the credit were normalized under one of the two normalization options in the Code. However, utilities that were on a flow-through method of accounting for accelerated depreciation were generally allowed to flow through the investment credit. (In the 1975 Act, the limit on the amount of tax liability offset by investment credits also was increased temporarily for most public utilities because low earnings and tax liabilities were leaving utilities with large amounts of unused credits to carryforward.) When the investment credit for public utility property was

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[3] Public utility property is not eligible for the energy investment credit except for small-scale hydroelectric property, equipment used to produce oil shale or gas from geopressured brine, and perhaps specially defined energy conserving property.

increased to 10 percent in 1975, it was provided that flow-through could not be utilized by these grandfathered utilities with respect to the additional 6 percent credit (or the additional credit allowable by reason of increased limitation based on tax liability) unless the company made a specific election. This rule was retained when the 10-percent rate was made permanent in 1978.

In general, present law (Code sec. 46(f)) denies the investment tax credit (both the regular credit and any allowable energy credits) with respect to public utility property if a public utility regulatory commission requires that the credit be immediately flowed through to customers or if the benefits of the utility's retention of the credit are not shared between utility customers and utility shareholders in a manner prescribed by one of the normalization options in the Code.

Under certain exceptions, however, the benefits of the investment tax credit may be flowed through immediately to customers if an election is made and if the taxpayer was on a flow-through method of accounting for depreciation purposes prior to 1969. As mentioned above, this immediate flow-through rule applies only to investment credit which would have been allowed under the rules in effect prior to 1975; the increase first provided with respect to public utility property in 1975 must be accounted for under a normalization method of accounting (Code secs. 46(f)(3) and (8)).[4]

Except for the special flow-through rules in the preceding paragraph, the investment credit is denied for public utility property if the ratemaking treatment of the credit results in the utility's shareholders receiving less than the benefit prescribed by (a) the ratable flow-through method or (b) the rate base reduction method, whichever is applicable.

Under the ratable flow-through method, the benefits of the investment credit may be shared with utility customers by passing through to them no more than a ratable portion of the investment credit during a period equal to the useful life of the asset that produced the credit. The ratable portion is equal in amount to the regulated depreciation allowance on that portion of the cost of the equipment paid for, in effect, by the credit. However, the utility shareholders must be allowed a return on the capital represented by the credit, just as with the private capital of the utility. In this manner, the benefits of the investment credit are shared by passing through to customers the equivalent of the depreciation allowance on the portion of the purchase price of the property paid for by the credit and by requiring that the utility earn a return on the investment that, in effect, has been supplied by the credit.

Under the rate base reduction method, the utility's rate base is reduced by the amount of the credit, so that the shareholders are pre-

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[4] However, a public utility which had elected flow through prior to 1975 could make another election to flow through the additional credit. This additional election was structured so that it normally could be made by the company and not by direction of the regulatory commission.

Special rules are also provided to prevent flow through of the additional credit for contributions to an employee stock ownership plan (Code sec. 46(f)(9)).

vented from earning a return on that part of the cost of the equipment which is, in effect, paid for by the credit. However, under this method, the regulatory commission may not require that the utility flow through to customers any part of the credit itself, and it must allow the utility to charge customers for the depreciation expense on the entire cost of the equipment, including the part paid for by the investment credit.

B. Background

Accelerated depreciation methods and the investment tax credit were enacted in order to encourage higher rates of investment in plant and equipment. This result is achieved by increasing the estimated rate of return after taxes over the life of the asset involved through reducing the initial cost of the investment or making possible a more rapid recovery of the funds invested in capital assets.

When it considered the Tax Reform Act of 1969, Congress found that public utility regulatory agencies were adopting very different methods of flowing through to customers the tax benefit from accelerated depreciation. About half the regulatory agencies required utilities that used accelerated depreciation to flow through the tax reduction from accelerated depreciation immediately in the form of lower rates. Some agencies insisted that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, treated the utilities as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have used straight-line depreciation on their tax returns. Other agencies permitted the utilities under their jurisdiction to normalize the deferred tax liabilities resulting from accelerated depreciation (i.e., permit the company to retain the temporary tax savings but pass through to customers the resulting cost of capital savings). The trend, however, appeared to be towards use of immediate flow-through. As a result, Congress decided, as part of the Tax Reform Act of 1969, essentially to freeze the then current situation with regard to the circumstances under which accelerated depreciation methods could be used by a regulated public utility.

The freeze applied to existing property as of August 1, 1969. It permitted most flow-through practices to continue, but provided that subsequent changes to a faster rate of depreciation for Federal income tax purposes would not be allowed.

For new (i.e., post 1969) property, a public utility generally was allowed to flow through the tax benefits from accelerated depreciation if that was the practice as of August 1, 1969. In all other cases, straight-line depreciation was required unless the tax benefits from accelerated depreciation were normalized.

When Congress restored the investment tax credit at a 7-percent rate in the Revenue Act of 1971, the investment credit for public utilities was increased from 3 percent to 4 percent. The increased credit was provided because many utilities were encountering problems in raising capital for modernization and expansion. An additional reason for the increased credit was to improve the competitive position of regulated utilities against unregulated companies which provide some of the same services.

When Congress restored the investment credit in 1971, it provided that the investment credit would not be available in cases where the

credit was immediately flowed through to customers or where some of the benefits of the utility's retention of the credit were not retained by the utility as provided under one of the normalization options in the Code. However, utilities that were on a flow-through method of accounting for accelerated depreciation were generally allowed to flow through the investment credit. When the investment credit for public utility property was increased to 10 percent in 1975, it was provided that, for the most part, flow through could not be utilized by these grandfathered utilities with respect to the additional 6 percent unless the company made an election. This rule was retained when the 10-percent rate was made permanent in 1978.

Considerable controversy has arisen over the proper application of these normalization rules, principally in California. Prior to 1969, the California Public Utilities Commission generally required utilities under its jurisdiction to flow through the tax benefits of accelerated depreciation to customers immediately. However, in accordance with Code provisions making the use of accelerated depreciation elective, Pacific Telephone and Telegraph Company and General Telephone Company of California, the telephone companies under the Commission's jurisdiction, did not elect to take accelerated depreciation for Federal tax purposes. In a 1968 decision, the Commission found that it was imprudent for the companies to use straight-line depreciation for Federal tax purposes, and the Commission set rates as if accelerated depreciation had been elected, and it flowed through the tax benefits of this imputed accelerated depreciation to the customers. This 1968 decision was modified by the Commission in 1970 to allow the companies to elect accelerated depreciation with normalization as prescribed by the Code. However, in 1971 the California Supreme Court annulled the 1970 decision on the grounds that (1) the 1968 decision did not have to be modified because of the intervening passage of the Tax Reform Act of 1969 rules requiring that public utilities (other than public utilities which had previously used accelerated depreciation and flowed it through to their customers) could elect accelerated depreciation only if the benefits of such depreciation were normalized and (2) other methods of normalization should have been considered.

After protracted litigation (including 3 more decisions of the California Supreme Court), the Commission entered an order which requires the telephone companies to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers. Although no final determination has been made as to whether these methods comply with the Code's normalization requirements, the Internal Revenue Service has issued private rulings which take the position that the methods do not comply with such requirements. As a result, these telephone companies are faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment credit even though all or a portion of these benefits may have already been reflected in reduced rates or refunds for their customers. At least one other utility (Southern California Gas Company) apparently has a similar problem with respect to that portion of the investment credit which is subject to the "anti-flow-through" rules of the 1975 Act.

C. Issues

One major issue is whether it is desirable to clarify for the future the rules relating to normalization with the intention of preventing further disputes of the type which has occurred in California. The other major issue is whether it is appropriate to provide a special rule that would exempt utilities from the normalization requirements of present law for accounting periods that ended prior to March 1, 1980, if the utilities used certain accounting methods which were prescribed by an order of a public utility commission entered prior to March 13, 1980.

D. Explanation of Provisions

The bill contains two amendments to the normalization rules which would not materially change the substance of present law as that law is interpreted by Treasury regulations. It also contains a special rule applicable to periods prior to March 1, 1980, and designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of A.T. & T.), General Telephone Company of California (a subsidiary of General Telephone & Electronics), and Southern California Gas Company.

1. Accelerated depreciation

The bill would add a new provision (Code sec. 167(l)(3)(H)) which clarifies the present definition of the normalization method of accounting (in Code sec. 167(l)(3)(G)) for accelerated depreciation in a manner which generally follows the interpretation of this provision now contained in Treasury regulations.

This added provision generally would provide that normalization is not complied with if, for ratemaking purposes, a procedure or adjustment is employed which uses estimates or projections of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless these estimates and projections are also used in determining the other two such items and the rate base.

The Treasury also would be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with normalization. This specific authority to prescribe regulations would not be intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision would be intended to make it clear that California's so-called "AAA" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the normalization requirements of Code section 167(l)(3)(G).

2. Investment tax credit

The bill would add a new provision (Code sec. 46(f)(10)) to the rules relating to normalization of the investment tax credit. The new provision generally would provide that the normalization rules are not complied with if a procedure or adjustment is employed which uses an estimate or projection of the taxpayer's qualified investment for purposes of the investment tax credit unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

The Treasury Department also would be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with the requirements of the rate base method

or the ratable flow-through method. This specific authority to prescribe regulations would not be intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision would be intended to make it clear that California's so-called "AA" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the requirements of Code section 46(f).

The new Code provisions which would be added by the bill (new Code secs. 46(f)(10) and 167(l)(3)(H)) would specify only one manner in which the normalization rules may be violated. Thus, compliance with these provisions would be a necessary but not sufficient condition for eligibility for the investment tax credit and accelerated depreciation.

3. Special rule for periods prior to March 1, 1980

The bill would provide that violations of the normalization requirements of present law (and of the bill) would not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if (a) such violations involved the use of estimates, projections, or adjustments to the taxpayer's rate of return and (b) such estimates, projections, or adjustments only applied for any period ending prior to March 1, 1980, and were included in a qualified order. For purposes of this special rule, a qualified order would be an order of a public utility commission—(1) which was entered before March 13, 1980, (2) which used the estimates, projections, or rate of return adjustments to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and (3) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced). Since the special rule would apply to rates which were determined for periods prior to March 1, 1980, an order may be a qualified order even if it requires that refunds be paid after March 1, 1980, so long as such refunds are attributable to adjustments to rates charged prior to that date.

As indicated above, this transitional rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company.

4. Effective date

The provisions of the bill (other than the special rule) generally would apply to taxable years beginning after December 31, 1979. However, these provisions could be overridden by the special rule for periods prior to March 1, 1980.

The bill would explicitly provide that, in applying the normalization rules (Code secs. 46(f) and 167(l)(3)) to taxable years beginning before January 1, 1980, no inference is to be drawn from the amendments to these rules (new Codes secs. 46(f)(10) and 167(l)(3)(H)) or from the special rule. However, this no inference rule would not be intended to limit the relief provided by the special rule.

The bill also would provide that no refund or credit of any overpayment of tax attributable to the bill would be made or allowed prior to October 1, 1981.

E. Revenue Effect

It is estimated that the permanent changes made by the bill would have no revenue effect.

If the orders of the California Public Utilities Commission applicable prior to March 1, 1980, to the three utilities which would be benefitted by the special rule do *not* comply with the current normalization rules in the Code, the special rule in the bill would result in a revenue loss of approximately $1.85 billion attributable to accounting periods prior to March 1, 1980. Approximately $110 million of this amount has been paid into the Treasury and could be the subject of claim for a refund which could be filed at any time through February 1982. Since the bill provides that no refund or credit of any overpayment of tax attributable to the provisions of the bill could be made or allowed prior to October 1, 1981, the $110 million of revenue loss would probably occur in fiscal year 1982. The remainder of the $1.85 billion revenue loss generally would occur in the fiscal year or years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal year after 1981

If these orders do comply with the current normalization rules, the special rule in the bill would result in no revenue loss as long as orders in effect for periods after March 1, 1980, are in compliance with the revised normalization rules.